

### Section 3 Urgent measures to strengthen locational competitiveness

In the age when enterprises choose countries, strengthening locational competitiveness is indispensable for Japan to prevent the hollowing out of industry and accomplish sustainable economic growth. In this section, measures to be taken swiftly are discussed.

#### 1. Reduction in corporate taxes to reinforce the competitive edge of enterprises

When enterprises choose business locations, market conditions are an important factor, while the burden levels of social security and others, including effective corporate tax rate, are also important.

In Japan, the tax reforms in the late 1990s lowered the effective corporate tax rate, and since then it has remained almost unchanged until the recent reduction. Meanwhile, effective corporate tax rates have been lowered in many OECD and EU countries, along with the expansion of the tax base (Figure 4-3-1-1).

As a result, the effective corporate tax rate in Japan has remained relatively high by international standards (Figure 4-3-1-2).

Figure 4-3-1-1  
Effective corporate tax rate

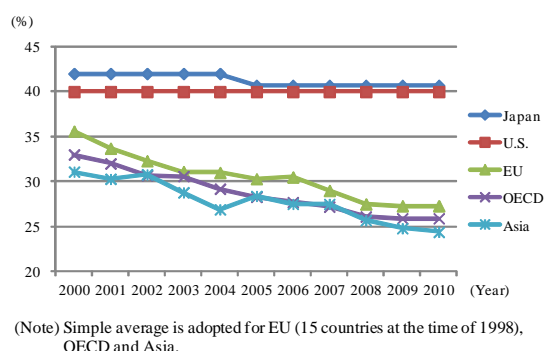
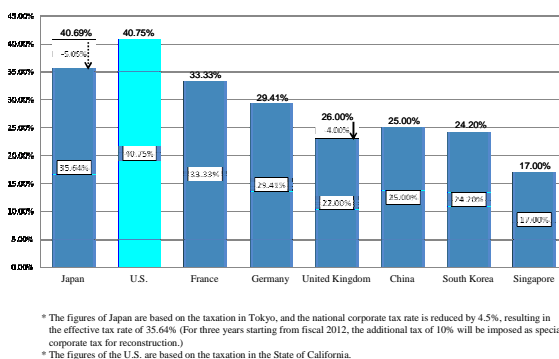


Figure 4-3-1-2  
International comparison of effective corporate tax rate



**(1) Recent trends for corporate taxes in major countries**

**(A) United States of America**

President Obama announced that the corporate tax rate would be cut from 35% to 28% under tax reform guidelines published in February 2012. To compensate for the resultant revenue decline, the abolition and reduction of the preferential tax system was incorporated in the guidelines, while further preferential tax treatment for the manufacturing industry was mentioned.

**(B) United Kingdom**

In the United Kingdom, according to the draft budget for fiscal 2012, the corporate tax was cut from 26% to 24% in April 2012, and it will be reduced by 1% every year until 2014. (The rate will be 22% in April 2014.)

As effective corporate tax rates have been cut in major countries, from the perspective of reinforcing the international competitiveness of enterprises located in Japan, the reduction of the effective corporate tax rate was positioned as one of 21 national strategy projects, “7. Promotion of Effective Corporate Tax Rate Reduction and Japan as an Asian Business Center,” in the “New Growth Strategy Blueprint for Revitalizing Japan,” which was approved by the Cabinet on June 18, 2010 (Table 4-3-1-3).

Table 4-3-1-3  
New Growth Strategy Blueprint for Revitalizing Japan (June 18, 2010)

7. Promotion of effective corporate tax rate reduction and Japan as an Asian business center  
In order to reinforce the international competitiveness of enterprises located in Japan and encouraging foreign enterprises to choose Japan as a business location, the effective corporate tax rate shall be reduced to a comparative level to major countries. In this regard, all tax measures, including special measures concerning taxation, shall be fundamentally reviewed, and securing financial resources, including expanding the tax base, shall be considered. The tax rate shall be reduced in a step-by-step manner, bearing in mind that securing employment and improving an environment for the business location are pressing issues. (The rest is omitted.)

In line with policies in the new growth strategy and from the perspectives of reinforcing the international competitiveness of domestic enterprises, encouraging foreign enterprises to choose Japan as a business location, and expanding employment and domestic investment, a bill for the fiscal 2011 revision of the tax system, which incorporated the 5% reduction of the effective corporate tax rate, was passed in November 2011, and the rate will be reduced from fiscal 2012 (Table 4-3-1-4). For three years starting from fiscal 2012, the additional tax of 10% will be imposed as special corporate tax for reconstruction (Figure 4-3-1-5).

Table 4-3-1-4

Outline of integrated reform of social security and taxation systems (February 17, 2012)

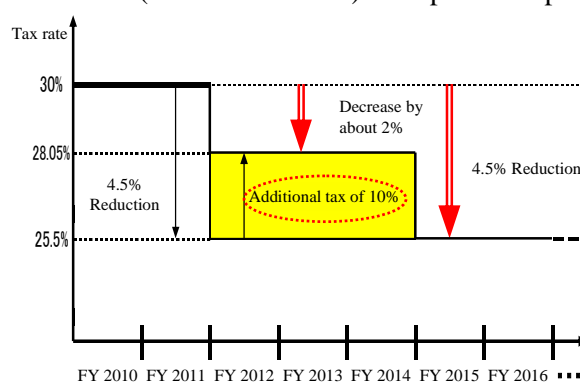
3. Corporate taxation

For corporate taxation, it is necessary to maintain and improve the competitive edge of enterprises, ensure and encourage enterprises to choose Japan as a business location, and expand employment and domestic investment, while taking into account such factors as international collaboration.

From this perspective, in the fiscal 2011 revision of the tax system, the corporate tax rate is reduced by 4.5% (applied starting from fiscal 2012), along with the expansion of the tax base. As for reduced tax rate for small and medium-sized enterprises (SMEs), the rate is reduced, along with a review of special measures concerning taxation related to SMEs. (The rest is omitted.)

Figure 4-3-1-5

Image of corporate tax rate reduction (for national taxes) and special corporate tax for reconstruction



Source: materials of the tax commission.

**2. Attracting global enterprises with proactive initiatives being called on**

As global enterprises establish business bases in Japan and introduce new technologies and management methods therein, domestic markets will become increasingly active. With the intensification of international competition in attracting enterprises, Japan is called on to take proactive initiatives.

**(1) Toward promoting Japan as an Asian business center**

With the recent Asian emerging countries' reinforcement of support measures to attract global enterprises and the relative shrinkage of Japanese markets resulting from the economic growth of Asian emerging countries, the withdrawal of global enterprises from Japan has occurred in a successive manner and Japan has been losing the leading position of an international base for business activities. However, global enterprises expanding into Japan will bring about new technologies, management methods and others in Japan, and this is indispensable to the future growth of the Japanese economy. With such conditions in mind and based on the "New Growth Strategy Blueprint for Revitalizing Japan," which was approved by the Cabinet on June 18, 2010, the government has worked on attracting enterprises for high-value added bases, as typified by a research and development base and an Asian head office.

After the Great East Japan Earthquake, "Basic Policy for Reconstruction from the Great East Japan

Earthquake” (decision of the Reconstruction Headquarters in response to the Great East Japan Earthquake on July 29, 2011) and “Comprehensive Measures Against the Higher Yen” (Cabinet decision on October 21, 2011) were established and they incorporated concrete measures to channel various vitalities of foreign countries into Japan under the difficult economic conditions surrounding Japan, marked by the effects of the Great East Japan Earthquake and the higher yen. These measures included reconfirming the importance of developing an investment environment to encourage global enterprises to establish the functions of a research and development base and an Asian head office.

The “Basic Strategy for the Revitalization of Japan,” which was approved by the cabinet on December 24, 2011, declared that measures incorporated in the “New Growth Strategy” (approved by the Cabinet in 2010) shall be re-examined and strengthened to solve issues confronting Japan, including the effects of the Great East Japan Earthquake. In the basic strategy, measures for Japan as an Asian business center are described as follows: as part of “(1) Initiatives to Further Strengthen Growth Potential (Opening Up Economic Frontiers),” the government aims to create business and living environments that are attractive by international standards, based on the “Program for Promoting Japan as an Asian Business Center and Direct Investment into Japan;” and a bill for promoting Japan as an Asian business center shall be passed at an early date.

## **(2) Concrete initiatives to promote Japan as an Asian business center**

Based on the aforementioned background, the government has been promoting measures for Japan as an Asian business center. To attract global enterprises, it is vital that the whole government should work together to develop the business environment for global enterprises and the living environment for foreigners, together with incentive measures. Thus, the “Program for Promoting Japan as an Asian Business Center and Direct Investment into Japan,” which comprehensively compiled related measures and others, was formulated on December 16, 2011. Under this program, each of the relevant ministries, agencies and other bodies shall steadily promote efforts to attract global enterprises.

The program specified three targets of “increase of high-value added bases (30 cases of invitation per year)” “doubling of employees by foreign enterprises (0.75 million individuals → 2 million individuals)” and “doubling of foreign direct investment in Japan,” which shall be accomplished by 2020. To achieve these targets, measures to be taken by the government were organized in the program. Specifically, individual measures shall be promoted in line with the following five pillars: 1. strengthening locational competitiveness of Japan by reinforcing incentive measures for global enterprises, including subsidy programs and tax systems; 2. encouraging investments by utilizing the comprehensive special zone program and others so as to create employment in local regions; 3. promoting the development of business environment through such methods as developing social infrastructure, reviewing regulations and others, improving the transparency of administrative procedures, and using English in administrative affairs; 4. promoting the development of a better living environment through such method as improving education and medical care for foreigners; and 5. promoting the government’s PR activities to emphasize the appeal of locational environment of Japan and enhancing the dissemination of information to eliminate harmful rumors (Figure 4-3-2-1).

Figure 4-3-2-1

Outline of program for promoting Japan as an Asian business center and direct investment into Japan

◆ <b>Targets specified in the program, which shall be accomplished by 2020</b>	Decided on December 16, 2011 by the Committee for Promoting Japan as an Asian Business Center and Direct Investment into Japan
<b>1. Increase of high-value added bases (30 cases of invitation per year)</b> <b>2. Doubling of employees by foreign enterprises (0.75 million individuals → 2 million individuals)</b> <b>3. Doubling of foreign direct investment in Japan</b>	
◆ <b>Five pillars and major concrete measures</b>	
<b>1. Improving profitability to promote investment</b> The government shall strengthen locational competitiveness of Japan by reinforcing incentive measures for global enterprises, including subsidy programs and tax systems, to create a world-class investment environment. Subsidy program for projects promoting Asian site location, bill for promoting Japan as an Asian business center, 5% reduction of the effective corporate tax rate and others.	
<b>2. Utilizing the special zone system and others to lure investments</b> The government shall, in coordination with local governments, lure investments from home and abroad by utilizing the comprehensive special zone program, reconstruction special zone, and others. International strategy comprehensive special zone, reconstruction special zone and others.	
<b>3. Developing investment environment and establishing investment support system</b> In order to increase the flow of people, goods and money, the government shall develop social infrastructure and review regulations and others, while improving transparency of administrative procedures and using English in administrative affairs. Preferential treatment for immigration control using a point program, reinforcement of one-stop service in administrative procedures, review of procedures for the examination of medical equipment and medicine, promotion of using English in administrative affairs, and others.	
<b>4. Creating a more friendly living environment as an investment destination</b> The government shall promote the development of living environment through such method as improving education and medical care for foreigners. Development of an environment friendly to foreigners in medical institutions, development of international schools and others.	
<b>5. Enhancing the dissemination of information to welcome investment</b> The government shall promote its PR activities to emphasize the appeal of locational environment of Japan and disseminate information to eliminate harmful rumors. PR activities in international conferences and other occasions, the dissemination of information using English and others.	

Source: Ministry of Economy, Trade and Industry.

As mentioned in the aforementioned program, in order to attract global enterprises, it is effective to take the same measure as other Asian emerging countries, namely providing direct incentives to global enterprises. As such, in February 2011 the Ministry of Economy, Trade and Industry submitted to the 177th ordinary session of the Diet a “Bill on Special Measures Concerning the Promotion of Research and Development by Specific Multinational Enterprises,” which prescribes the implementation of measures to provide such treatment as reducing the burden of corporate tax and patent fees for the research and development and supervising activities of global enterprises (the bill has been deliberated in the 180th ordinary session of the Diet) (Figure 4-3-2-2).

In addition to the incentive measures in the aforementioned bill, the “Subsidy Program for Projects Promoting Asian Site Location in Japan,” which is designed to provide subsidies for an initial cost pertaining to global enterprises’ establishing high-value added bases in Japan, was launched from the supplementary budget for fiscal 2010, and 10 businesses were adopted for this program in December 2011. The type of the businesses adopted includes a broad range of growth fields, including medicine, fuel cells, and automobile-related technology (Figure 4-3-2-3).

Furthermore, since the Great East Japan Earthquake it has become increasingly important to disseminate accurate information regarding a business environment in Japan and promote PR and invitation activities to attract enterprises. Therefore, the government has been continuing to work on such measures as engaging in publication activities for global enterprises and creating matching opportunities with Japanese enterprises. Apart from these measures, as mentioned in the “Program for

Promoting Japan as an Asian Business Center and Direct Investment into Japan,” the government shall further encourage global enterprises to choose Japan as a business location by utilizing the comprehensive special zone program and others (Figure 4-3-2-4).

Figure 4-3-2-2

Outline of a bill on special measures concerning the promotion of research and development by specific multinational enterprises

○ In order to promote attracting global enterprises to Japan for a research and development base and an Asian head office, the government shall implement measures to provide global enterprises approved by the relevant minister with such treatment as reducing the burden of corporate tax and patent fees.

**Targets**

<p><b>(1) Research and development base</b></p> <p>Concentrating sophisticated researchers, etc., who are indispensable to innovation</p>	<p><b>(2) Asian head office</b></p> <p>Concentrating sophisticated managers, etc. who are indispensable in the global economy and society</p>
---	---

**Incentives**

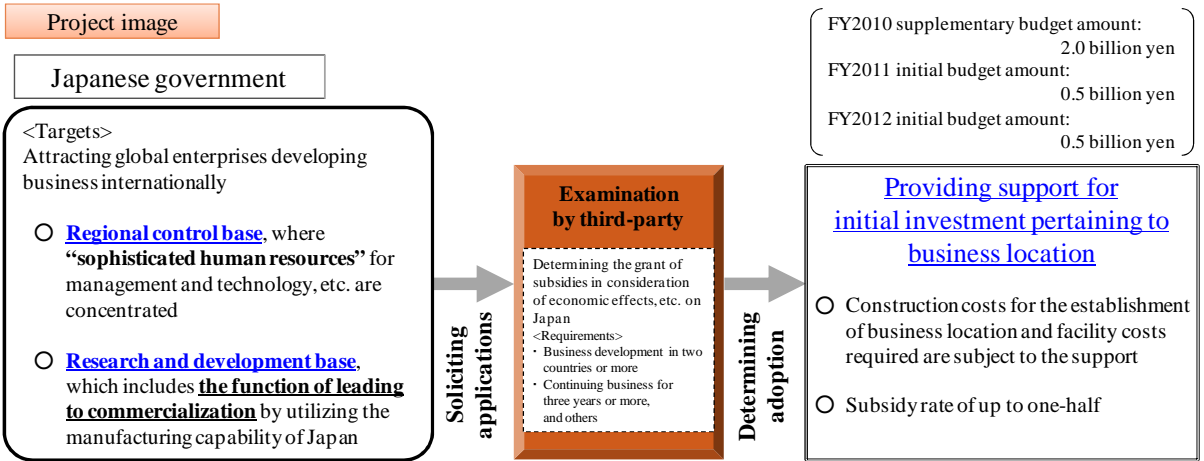
- Corporate tax** ○ 20% income deduction for five years for approved enterprises
- Individual income tax** ○ Stock acquisition rights granted by foreign parent companies to directors, etc. of approved enterprises are subject to the stock option taxation, and the taxation is deferred until the time of transfer.
- Patent fee** ○ Patent fees, etc. are reduced for approved research and development business operators.
- Foreign exchange law** ○ For a notification pertaining to domestic direct investment, etc., a legally prescribed period for inaction is reduced (30 days → two weeks).
- Fund-raising** ○ Subscription of stock by the Small and Medium Business Investment & Consultation Corporation (among SMEs, stock companies with capital of more than 300 million yen are also subject to this.)

\* For foreign nationals who are to work at approved enterprises, period for the immigration clearance in disembarkation procedures (authorization of resident eligibility) is shortened (generally one month → about 10 days)

Source: Ministry of Economy, Trade and Industry.

Figure 4-3-2-3

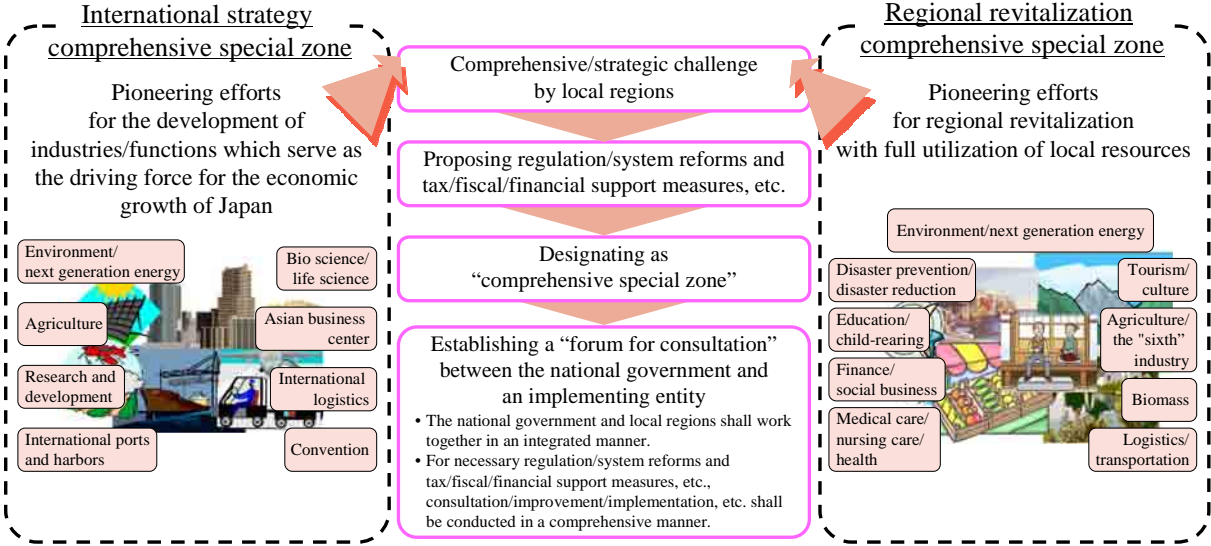
Outline of subsidy program for projects promoting Asian site location



Source: Ministry of Economy, Trade and Industry.

Figure 4-3-2-4  
 Outline of comprehensive special zone program

Through two types of “comprehensive special zone,” the government aims to enhance international competitiveness, etc. by promoting the establishment of business bases and improve regional power with full utilization of local resources.



Source: Regional Revitalization Bureau, Cabinet Secretariat.

**3. Enhancement of subsidies for location meeting needs**

With the rapid progress of the hollowing out of industry resulting from the earthquake and the higher yen, there is growing concern about the loss of employment. In order to attract further domestic investment, it is vital to enhance subsidies for location as a quick-impact measure to strengthen locational competitiveness.

**(1) Implementing subsidies for domestic location to strengthen locational competitiveness**

Enterprises affected by the Great East Japan Earthquake included those forming the core of supply chains. Due to the impact of the lagging reconstruction of such enterprises, the production was suspended at downstream manufacturers of finished products for a long time, leading to a nationwide disruption of production. This was because: the supply chains had become complex, and downstream manufacturers of finished products had not fully understand the whole context of the situation; and the production of some of parts/materials that were difficult to substitute was concentrated in specific companies (Figure 4-3-3-1).

In particular, with respect to some of parts/materials with leading global shares that were difficult to substitut, the impact spread to the production of finished products in countries other than Japan.

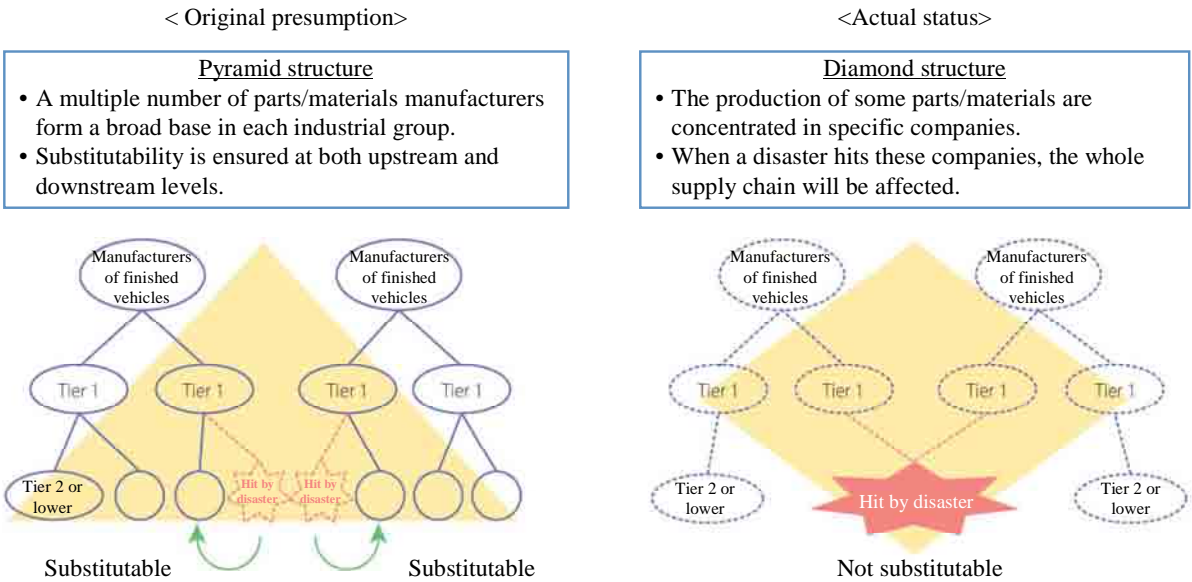
As the risks of disruption in international supply chains became apparent, foreign governments have started focusing on attracting Japanese enterprises, mainly in fields of parts/materials, to take a leading role in the next generation industries (Figure 4-3-3-2).

For example, South Korea established the “comprehensive measures for parts/materials competitiveness,” and for 10 major core materials approximately one trillion won (about 80 billion yen) will be spent for R&D on domestic enterprises by 2018. Moreover, a 300 billion won parts/materials fund was founded mainly by the Korea Development Bank to acquire parts/materials enterprises overseas. Another example is that China positioned next generation vehicles as a strategy field and established a national policy team for electric vehicles to develop the vital parts industry (Figure 4-3-3-3).

Besides, such issues as the rapid yen appreciation and concern over electricity supply that occurred after the great earthquake have significantly lowered locational competitiveness of Japan, causing some enterprises in the core fields where future growth is expected to shift production bases overseas. As such, there is growing concern that the hollowing out of industry accelerates immediately. Failure to prevent enterprises with high international competitiveness from shifting their business overseas would lead to the loss of long-term international competitiveness of Japanese industry, and this could have an adverse effect on reconstruction from the great earthquake and the revitalization of the Japanese economy, which had been stagnant before the earthquake. Therefore, a quick-impact measure to attract investment by enterprises to Japan has been highly required.

Figure 4-3-3-1  
Increase of concerns over supply chain disruption

- Manufacturers of finished products formerly presumed that “pyramid structure” was formed, in which their suppliers purchased parts/materials from several vendors at each pyramid level and substitutability was thus ensured.
- However, in reality, the supply of parts/materials is concentrated in specific companies at the sub-subcontractor and lower levels, and substitutability is not ensured. (“diamond structure”)



Source: Ministry of Economy, Trade and Industry.



Figure 4-3-3-2

### Invitation of Japanese enterprises by foreign governments

Q. After the earthquake was there any offer of invitation from overseas/did offers of invitation increase?

- ➡ ○ 11 out of 161 companies answered “there was” or “increased.”
- Countries or enterprises which invited the answering companies:  
 China - 4 companies, South Korea - 2 companies  
 Singapore/Thailand/Malaysia/U.S./Canada – 1 company (respectively)

(Note) Since some companies did not answer the name of an inviting country, etc., the total number of the companies does not equal 11.

(Source) “Emergency questionnaire survey concerning state of supply chain restoration or hollowing out following the Great East Japan Earthquake.”

(Ministry of Economy, Trade and Industry)

<Movements of foreign governments, etc.>

City A, South Korea	Sends a delegation in May to attract investment by Japanese enterprises; considering the exemption of corporate tax for three years and income tax for seven years.
City B, South Korea	Plans to provide one-on-one consultations, with KOTRA (Korea Trade-Investment Promotion Agency) serving as an intermediary; intends to continue to attract companies through joint venture and the establishment of joint companies.
City C, China	(When visiting Japanese enterprises for the purpose of expressing sympathy after the earthquake) Comment: Now we understand that Japanese enterprises intend to accelerate industrial transformation. This is a chance to attract Japanese enterprises, and we would like to emphasize that our city is more superior than other cities in terms of transportation, hydroelectric power generation, human resources, technology and other aspects.

(Source) Formulated from various news reports by the Ministry of Economy, Trade and Industry.

Source: Ministry of Economy, Trade and Industry.

Examples of industry fields in which foreign governments are competing in attracting companies



Solar panels



Electric vehicles



Lithium-ion batteries

Figure 4-3-3-3

### China’s and South Korea’s strategy for acquisition of parts/primary materials enterprises

- Korea established the “comprehensive measures for parts/materials competitiveness.”
- (A) For 10 major core materials approximately one trillion won (about 80 billion) will be spent for R&D by 2018.
- (B) A 300-billion-won parts/materials fund was founded mainly by the Korea Development Bank to acquire parts/materials enterprises overseas.

**10 major core materials – World Premier Material (WPM)**

1. Environment-friendly Smart Surface Treated Steel Plates (POSCO)
2. Ultra-lightweight Magnesium Materials for Transport Planes (POSCO)
3. Energy-efficient Multi-function Nano Compound Materials (LG Chem Ltd.)
4. Multi-function Macromolecular Membrane Materials (Kolon Fashion Material)
5. Plastic Substrate Materials for Flexible Displays (Cheil Industries)
6. Electrode Materials for High Energy Secondary Batteries (Samsung SDI Co.)
7. Bio Medical Materials (AminoLogics)
8. Ultra-pure Silicon Carbon (SiC) Material (LG Innotek Co.)
9. Sapphire Single Crystal Materials for LEDs (Sapphire Technology)
10. Carbon Reducing-type Ketone Premium Textiles (Hyosung)

- China positioned next generation vehicles as a strategy field and established a national policy team for electric vehicles to develop the vital parts industry.
- In March 2011, BYD, a Chinese car manufacturer, announced that it would export new energy cars, including electric vehicles (EV), to Europe from October to December 2012.

Source: Ministry of Economy, Trade and Industry.

In fact, the “Basic Policy for Reconstruction from the Great East Japan Earthquake (July 29, 2011),” which was compiled by the Reconstruction Headquarters in response to the Great East Japan Earthquake, specified that subsidies for domestic location are provided for production bases and

research and development bases in the fields of parts/materials that constitute the core of supply chains and the high-value added growth fields that will help to maintain employment in the future. In accordance with the basic policy and others, subsidies for domestic location, the scale of which was significantly expanded from that of the subsidy for projects promoting location for low-carbon employment-creating industry (which had been highly effective in the past economic measures), were included in the third supplementary budget for fiscal 2011. Specifically, the budget amount was expanded greatly from the past subsidies for location, totaling about 500 billion yen. Moreover, the target fields included not only the low-carbon industry, but also the fields of parts/materials that constitute the core of supply chains and the high-value added growth fields. Subsidies for domestic location consist of the following: a subsidy provided for production bases in the fields of parts/materials that constitute the core of supply chains and the high-value added growth fields that will help to maintain employment in the future (subsidy for projects promoting domestic location - 295 billion yen); a subsidy provided for research and development bases (subsidy for advanced technology demonstration and evaluation facility development, and others - 35 billion yen); and a subsidy required for the reconstruction from the nuclear power disaster in Fukushima Prefecture (subsidy for business location for the industrial recovery of Fukushima - 170 billion yen).

The third supplementary budget was passed on November 21, 2011, the first solicitation of applications for the subsidy for projects promoting domestic location was started on November 29. In the first solicitation, 748 applications were made, and 245 of them were adopted, as a result of examination by a third-party committee from the perspectives of an employment-creating effect, the degree of concern of outflow to overseas, contribution to the reinforcement of supply chains, competitiveness and technology, spillover effects on local economies, and others. It is expected that the implementation of projects adopted in the first solicitation will induce approximately 1.26 trillion yen of capital investment, which amounts to six times over the amount of the subsidy, and this will have an effect of creating demand of approximately 4.9 trillion yen each year for supporting industries. In addition, the creation of employment of about 200,000 jobs is expected if the supporting industries are included.

## **(2) Promoting domestic location for innovative low-carbon technology- intensive industries**

### **(A) Significance of innovative low-carbon technology- intensive industries**

In order to maintain and strengthen the competitiveness of Japanese industry, it is necessary to continue to create innovation in the field of low-carbon technology that is highly effective in reducing carbon dioxide, including next-generation high-capacity lithium-ion batteries for electric vehicles and LED lights with a luminous efficiency nearly twice that of existing fluorescent lamps. To this end, it is essential to accelerate innovation process from research and development to full-scale mass production for these globally advanced, innovative low-carbon products. In this regard, building an initial production line (a so-called “Line No.1”) of successfully developed innovative low-carbon products is indispensable in particular to the establishment of technology for full-scale mass production. However, the bottleneck for the innovation process is the large amount of capital investment required. Therefore, it is required to implement projects in which the government provide intensive support for domestic

investment to promote domestic location for innovative low-carbon technology-intensive industries, though they shall be limited to fields with the great future potential to reduce carbon dioxide, including LED and lithium-ion batteries, and to the case of building the initial production line. In addition to the aforementioned emergency measures in response to the earthquake, continuous support for research and development in Japan is required (Figure 4-3-3-4).

**(B) Outline of projects to promote domestic location for innovative low-carbon technology-intensive industries**

In fiscal 2011, 7.14 billion yen was appropriated in the budget as an expense required for projects to promote domestic location for innovative low-carbon technology-intensive industries. As a result of solicitation of applications, 22 applications were adopted, which were pertaining to capital investment for Line No.1 (initial production line) in technology fields that are important for the future low-carbon society, including lithium-ion batteries, solar batteries, LEDs, and components related thereto. It is expected that providing support for capital investment for Line No.1 (initial production line) will lead to the establishment of technology for full-scale mass production. Also in fiscal 2012, 7.08 billion yen is appropriated in the budget as an expense required for projects to promote domestic location for innovative low-carbon technology-intensive industries, and the projects will continue to be implemented (Figure 4-3-3-5, Figure 4-3-3-6).

Figure 4-3-3-4  
Concept of innovative low-carbon technology-intensive industries

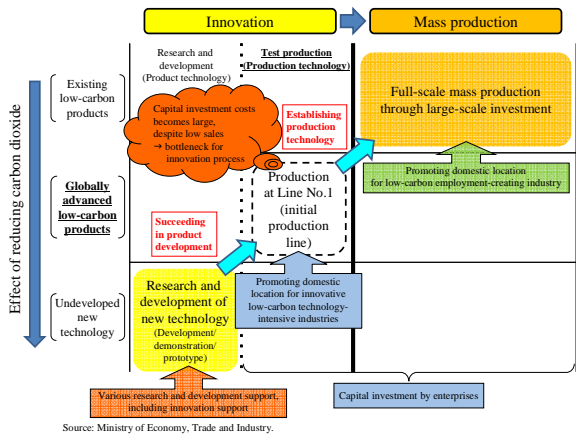


Figure 4-3-3-5

Image of the project for promoting domestic location for innovative low-carbon technology- intensive industries

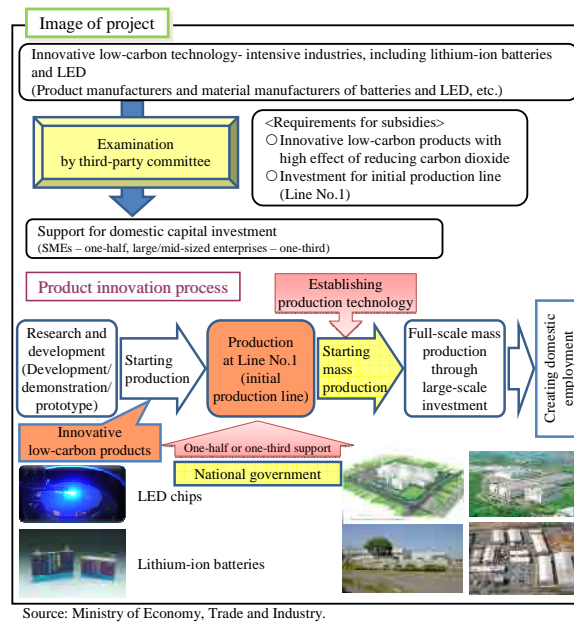
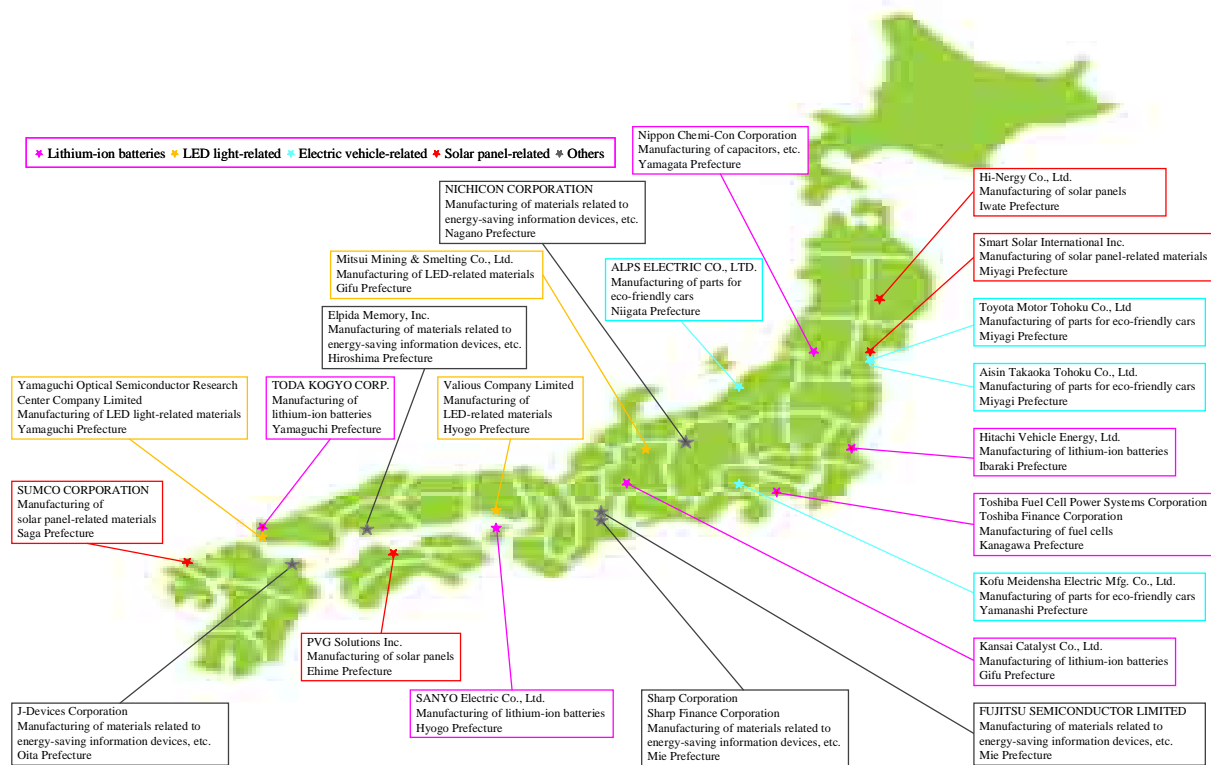


Figure 4-3-3-6

Adoption of the project for promoting domestic location for innovative low-carbon technology-intensive industries



#### **4. Towards creating new industries that underpin the Japanese economy**

In order for Japan to achieve sustainable economic growth in the face of the change in population structure and social maturation, the transformation of industrial structure through the creation of new industries is indispensable, and the essential point is to promote the development of an environment conducive to the growth of new industries.

##### **(A) Creating new industries and transforming industrial structure (from “flamingo-style batting” to the structure of “Mt. Yatsugatake” with various core profit centers)**

The issue regarding the transformation from the industrial structure of “flamingo-style batting,” which depends solely on the automobile industry, to that of “Mt. Yatsugatake” with various core profit centers has been addressed since the failure of Lehman Brothers. Also, in order to eliminate concerns about hollowing out resulting from the recent yen appreciation, the creation of new industries has become increasingly required.

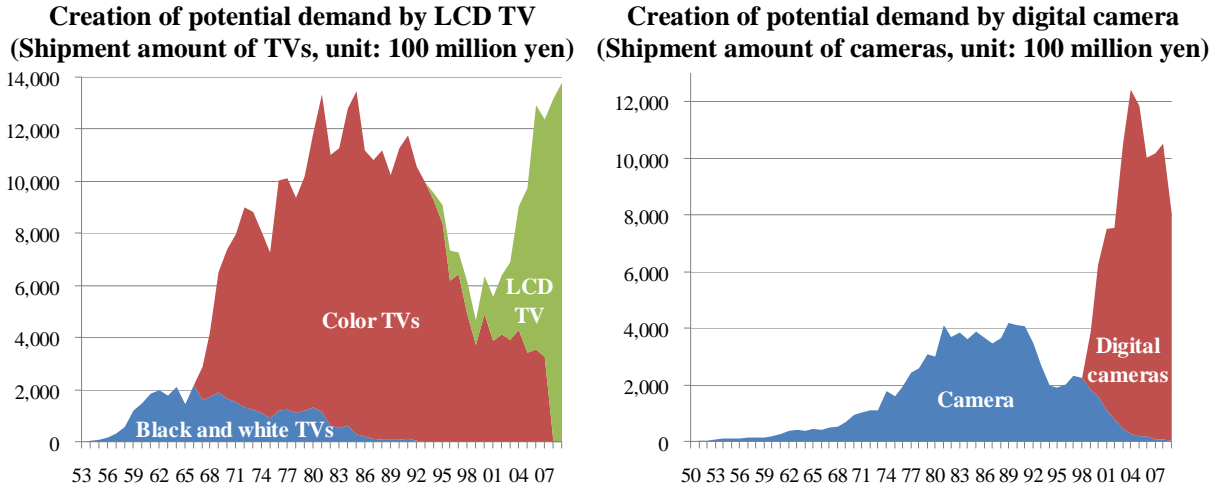
Looking at domestic demand, as the Japanese people are satisfied in terms of “material wealth,” social needs for “wealth of maturity” have been growing, creating a germ for new industries. In order to boost potential demand, it is essential to create industries that satisfy “wealth of maturity.” These industries have the potential in terms of export not only to industrialized countries in Europe and the U.S., whose economies are matured the same as Japan, but also to Asia, emerging countries and other areas, which are expected to grow toward social maturity.

The Japanese enterprises have historically developed potential demand through innovation so far. For example, in the 2000s the advent of innovative products, such as liquid crystal display televisions (LCD TVs) and digital cameras, have given an impetus to saturated domestic demand (Figure 4-3-4-1).

Innovation that develops such potential demand and the promotion of deregulation will create a “virtuous cycle of domestic demand expansion” consisting of: (A) enhancing the generation of added value by enterprises; (B) expanding high-quality employment and improving labor income; (C) overcoming anxiety over the future; (D) revitalizing domestic consumption; and (E) shaking off deflation. To this end, it is vital that fields that will boost potential domestic demand in the future and have great potential for growth to be developed as pillars for new industries (Figure 4-3-4-2).

Figure 4-3-4-1

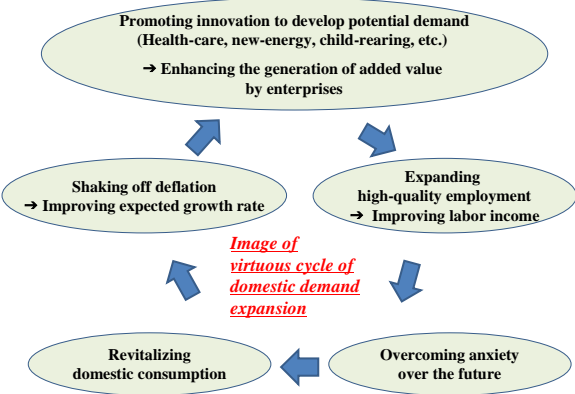
Creation of potential demand (shipment amount of TVs and cameras)



Source: Ministry of Economy, Trade and Industry.

Figure 4-3-4-2

Virtuous cycle of domestic demand expansion



Source: Ministry of Economy, Trade and Industry.

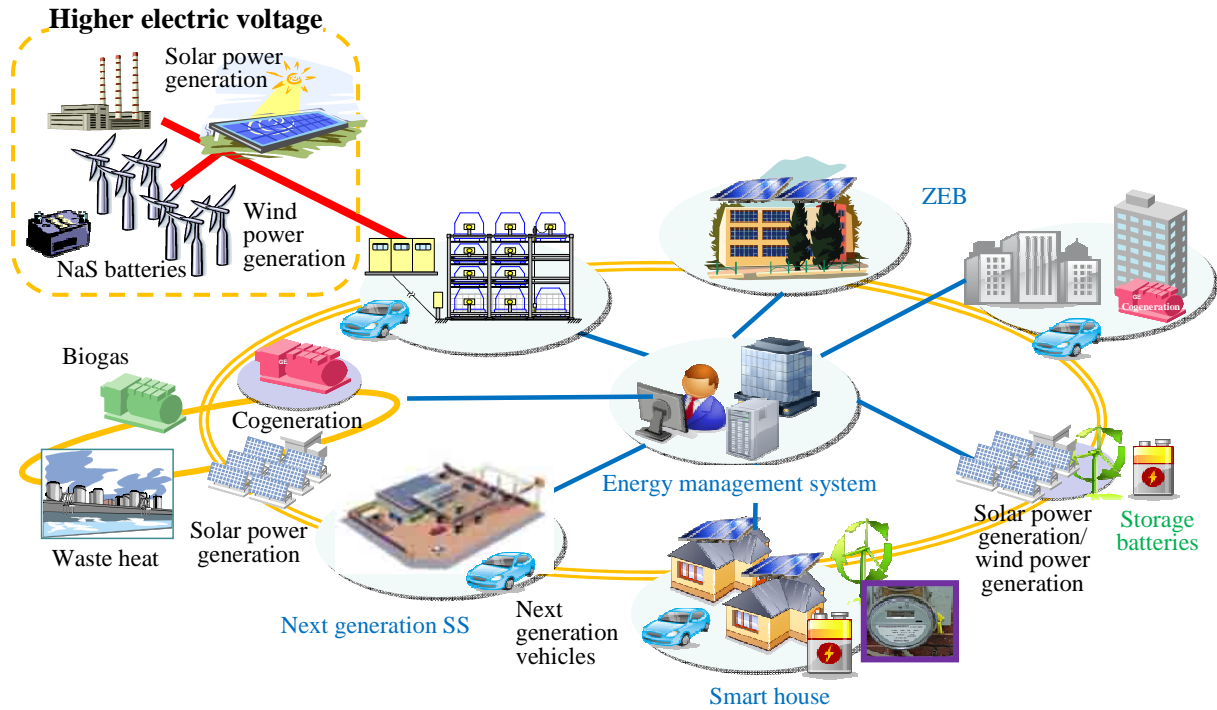
**(B) Three growth industry fields**

Considering future growth fields, significant growth is expected in three fields. The first is the industries that are designed to solve the problems confronting the Japanese society (problem solution-type industries). Compared to the rest of the world, an aging society with fewer children is progressing rapidly in Japan, emphasizing the need to expand healthcare services related to medical care and child-rearing services. Meanwhile, it is also possible to expand sales into Asia and other overseas areas. The export industry can emerge in the medical equipment field if excellent technology owned by small and medium-sized manufacturing enterprises is utilized. Furthermore, as there has been a growing need to restrict energy in Japan since the earthquake, the promotion of energy conservation and new energy use is absolutely required. The government will provide support for new growth fields, including the development of such equipment as storage batteries and the creation of

new business toward the full-scale introduction of smart community (Figure 4-3-4-3).

Figure 4-3-4-3

Smart community image



Source: Ministry of Economy, Trade and Industry.

Figure 4-3-4-4

Outline of a bill concerning the promotion of responses to economic and social problems

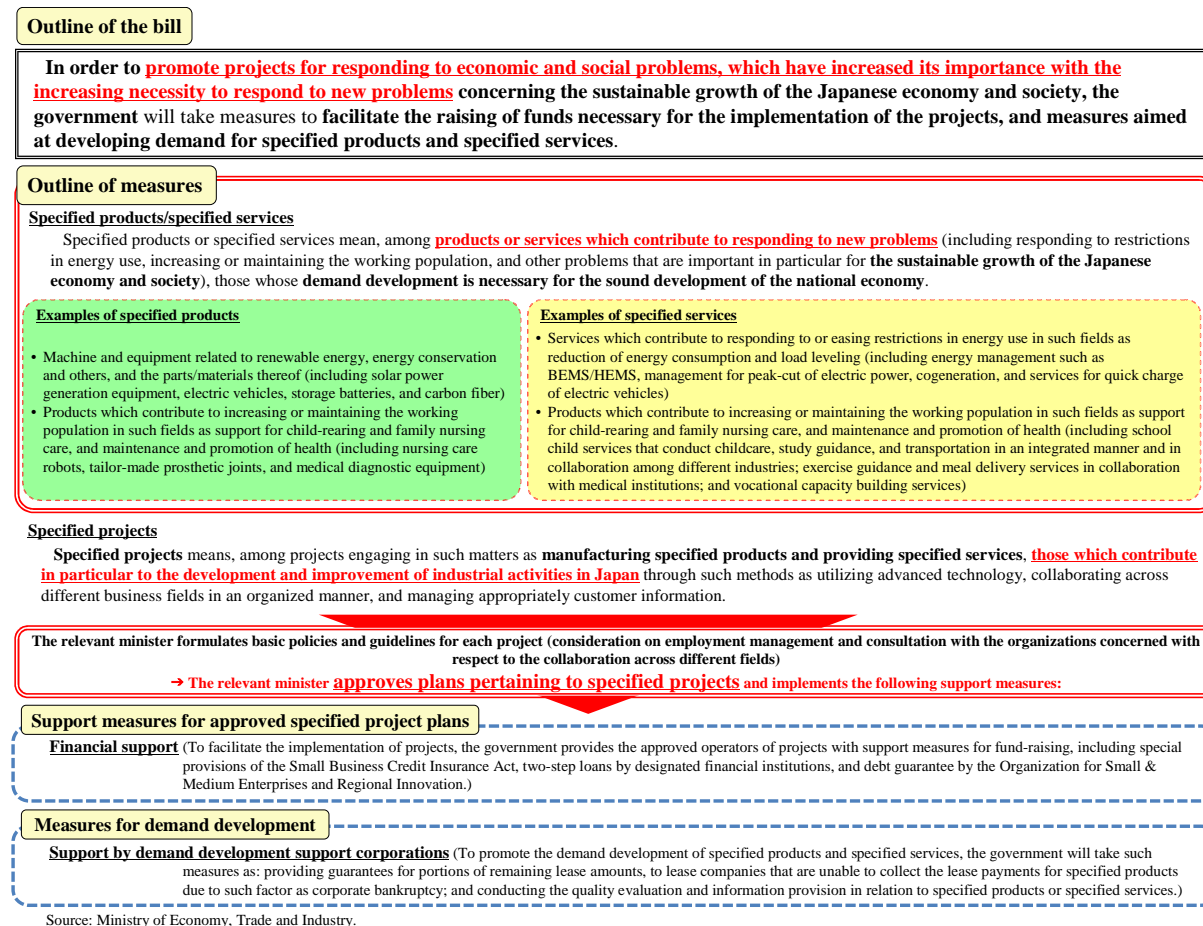


Figure 4-3-4-5

Overseas development of creative industry

<Overseas development of creative industry>

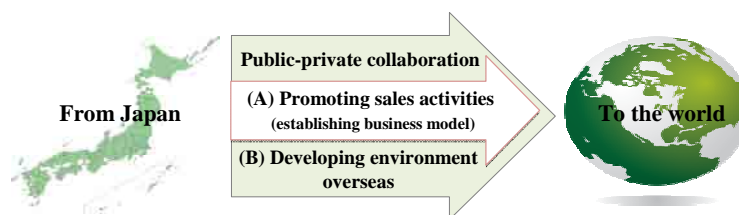
1. Promoting overseas sales activities related to Cool Japan

<Business descriptions>

- FS research
- Test marketing
- Advertising and publication
- Business matching and others

<Priority markets>

- Asia (China, India and South East Asia)
- Europe and the U.S.
- Brazil and others



2. Developing business environment overseas through dialogue between governments and international public-private dialogue
- Conclusion of memorandum of understanding regarding strengthening cooperation for the creative industry with foreign governments, and others

Source: Ministry of Economy, Trade and Industry.

With the aim of supporting the creation of these problem solution-type industries, a “Bill for



Promoting Business Addressing Socioeconomic Problems” is currently submitted to the Diet, and the government will develop pillars for new industries through financial support and other methods (Figure 4-3-4-4).

The second is the industries that utilize matured Japanese culture and sensitivity (creative industry), as discussed earlier, can be a great strength in future Japan (figure 4-3-4-5).

Figure 4-3-4-6  
Three growth industries



\* Method of forecasting market size differs in each industry.

The third is the leading-edge industries, including next generation vehicles, the aircraft and space industries, and these industries can lead to creation of new industries over the long-term. It is necessary to create innovative technology, rather than extending existing technology, and establish a system toward commercialization. Also, the government will promote international standardization in order to “win both in terms of technology and business” (Figure 4-3-4-6).

While the development of new industries shall be promoted as discussed above, global competition has been increasingly fierce, and weakening locational competitiveness of Japan has led to growing concern of hollowing out. Therefore, in addition to creating new industries, the government is called on to address the issue of hollowing out by providing subsidies for domestic location and others and also to develop a world-class business environment through such method as promoting economic partnership. Japan is approaching a critical point. At this very point of time, the implementation of

diverse measures is required.

## **Conclusion**

### **(Outline of the world economy)**

Since the second half of 2011, the world economy as a whole has slowed down due to such factors as the deteriorating European debt crisis and rising concern of the slowing U.S. economy, and the effect of monetary restraint in emerging countries. There was concern that the impact of the European debt crisis spread to the world, mainly emerging countries, in terms of trade and finance. However, the impact has been limited at present, compared to the world economic crisis from 2008 to 2009.

Entering 2012, thanks to a series of policy responses to the European debt crisis, the markets has regained stability to a certain extent, and, reflecting favorable weather factors and others, some economic indicators for the U.S. economy have shown positive signs. However, future uncertainty for the world economy has yet to be eliminated. In addition to the immediate tasks of fiscal reconstruction and recapitalization of banks, Europe has a structural problem of widening difference in competitiveness between countries, and a possible recurrence of the European debt crisis is still a large risk factor. Also, there is a need to keep a vigilant watch on the trends of the U.S. economy, which lacks strength in terms of housing markets and employment. In addition, attention should be given to the Chinese economy, which has shown signs of slowing down, as well as market trends for crude oil prices and other resource prices.

### **(Trade environment surrounding Japan in 2011)**

For Japan, the year 2011 has seen a series of historical events, which had a large impact on the trade environment. The damage caused by the Great East Japan Earthquake in March disrupted supply chains which had been built by the Japanese enterprises, and its impact spread not only in Japan, but also to the rest of the world. The yen appreciated in around summer, and the exchange rate of the yen against the dollar recorded an all-time high at the end of October. After the summer the European debt crisis deteriorated, and the slowing world economy exerted downward pressure on Japan's export. In October, the historical great flood in Thailand caused large damage to Japanese enterprises in Thailand and its supply chains. The trade balance of Japan for 2011 recorded a trade deficit for the first time in 31 years on a calendar year basis. Under such circumstances, renewed concern about the hollowing out of industry emerged.

### **(Trade and investment structure and its change in Japan)**

The trade structure of Japan has changed significantly since entering the 2000s. With the development of the Japanese enterprises' overseas activities, integration has deepened with respect to the international division of production mainly in East Asia, causing intermediary goods trade to increase greatly both in export and import. Thus, the ratio of export value to GDP, which had remained at about 10%, has risen to approximately 15%. Industrial structure which had formerly been called a "full-set type" has undergone change, and both the procurement of intermediary goods by way of import and the production inducement by external demand have become increasingly important for

domestic production. However, when compared to Germany, the degree of integration in the international division still remains at a low level.

The great flood in Thailand, together with the great earthquake in March, has left vivid impressions about the spread of supply chains that had been built by the Japanese enterprises and close ties between the Japanese economy and the international division structure in East Asia. Subsequently, with the rapid progress in the recovery of supply chains, production in the areas has recovered to the former level, and the areas remain attractive in terms of business locations. However, there has been a movement toward the review of suppliers for the diversification of risk.

**(Constructive issues that have arisen from trade deficit for the first time in 31 years and historical appreciation of the yen)**

The fact of Japan's first trade deficit in 31 years symbolized the difficult trade environment for Japan in 2011. About one half of the factors is attributable to a rise in import prices, while the other half is caused by a decrease in export volume and an increase in import volume. Specifically, the trade deficit was recorded mainly because: the crude oil prices soared, as the political situation has become unstable in the Middle East since the end of 2010; and, despite this, import volume of LNG, an alternative fuel for the crude oil, increased. Apart from these major factors, other factors include a decrease in export volume resulting primarily from supply restriction by the great earthquake, historical appreciation of the yen, and the slowing world economy.

The historical appreciation of the yen in 2011 was one of the factors of concern for the hollowing out in Japan. During the yen's appreciation this time, as import prices surged because of the soaring resource prices, the higher yen was not accompanied by improved terms of trade. It appears that the simultaneous occurrence of the appreciation of the yen and the deteriorating terms of trade has had a large negative impact on profitability of export enterprises in Japan. The trend of deteriorating terms of trade is stronger in South Korea, and export prices from South Korea have been falling greatly. This suggests that the intensifying competition as a result of the emergence of East Asian countries, mainly South Korea, have forced Japanese export enterprises to engage in a severe price war. Meanwhile, in Germany, both export and import prices have been stable, and there is no significant decline in profitability of export enterprises. It is presumed that one of the factors is German enterprises' strategy of securing a certain level of export prices by way of the differentiation in terms of technology and brands, rather than being involved in a price war. This could be one of elements in strengthening profitability of each enterprise and building strong economic structure that is not susceptible to the surge in resource prices and exchange rate fluctuation.

**(Advancing development of Japanese enterprises' overseas business and seizing growth opportunities)**

The development of Japanese enterprises' overseas business has expanded its domain and evolved from the existing scheme of large-scale manufacturing enterprises' developing global supply chains. SMEs and mid-sized enterprises also actively engage in export and foreign direct investment, and the industries which have been called the "domestic demand-type" so far, including non-manufacturing

industries, are also aggressively working on overseas business activities. A regional analysis reveals that the share of investment to North America and Europe is on a decreasing trend, and investment by China and other countries to Asia has been increasing rapidly. Reflecting an increase in importance of these areas as markets, the wholesale industry and service industry, and the wholesale business within the manufacturing industry have been developing overseas business.

Meanwhile, there has been a growing sense of awareness about the deteriorating business environment called the “six handicaps” in Japan, and there has been a movement toward the enhancement of foreign direct investment by Japanese enterprises, including foreign M&A, leading to growing concern about the hollowing out of industry. Generally speaking, in most cases a relation between foreign direct investment and domestic business activities is considered to be complementary, rather than alternative, and the argument that foreign direct investment is decreasing domestic production and employment does not sound persuasive at this point. However, in cases where the growth potential of the Japanese economy diminish in the future and the transitioning to new employment opportunities is impeded, attention should be given to the possibility that concern about the phenomenon of hollowing out, in which domestic business activities are switched to overseas, could become a reality. On the other hand, the development of overseas business improves efficiency in allocating resources within enterprises, creates spillover in technology and know-how, and heightens incentives for research and development, providing opportunities for domestic business to improve productivity and promote innovation. There is a chance that spreading the base of overseas business development will give rise to new growth opportunities.

#### **(Possibility of overseas business development by service industry)**

Focusing on the service industry in Japan, its values of export and import are not large compared to major countries, and its trade balance is recording a deficit. However, there are signs of changes, as seen in the fact that the margin of the deficit is on the decreasing trend, and the balance for Asia has already swung to the black. In recent years, in the service industry there are cases of receiving a certain level of praise overseas by way of the differentiation based on the value unique to Japan. This suggests that intangible value, including know-how and brand, which has been built by the Japanese service industry, has the potential to be disseminated to overseas. Furthermore, there is an expectation that tie-ups between the service functions and the manufacturing industry will lead to the production of high-value added products and the enhancement of competitive advantage.

#### **(Measures by Germany and South Korea to develop business environment)**

The development of domestic business environment is indispensable to channel overseas business development to domestic growth potential. In this regard, Japan can learn from measures by Germany and South Korea. Germany not only enjoyed the benefit of the single market with no exchange risk within the EU, but also worked on developing business environment through such methods as reforming labor markets, reducing corporate taxes and promoting research and development, and this has contributed to reinforcing the competitive edge of German enterprises. South Korea also actively supported overseas business activities of domestic enterprises, including large enterprises and SMEs,

and its presence in overseas markets has been heightened. At the same time, it has aggressively supported the advancement of domestic industry, while improving business environment through such methods as reducing corporate taxes, promoting free trade agreements, and encouraging business start-ups. Japan also has been striving to reinforce the competitive edge of Japanese enterprises, through an effort to improve business environment by promoting economic partnership and providing subsidies for location, and by methods such as reducing by 5% the effective corporate tax rate in fiscal 2011 revision of the tax system. However, apart from the measures mentioned above, foreign countries are implementing various other measures, and Japan has much to learn from them.

**(Epilogue: today's significance of trading nation)**

The term “trading nation” is commonly used today. However, the term originally represented one of the concepts presented in discussing the direction of post-war reconstruction, and the concept was based on the theory to solve economic issues of a country on a worldwide basis. Economic issues of a country can change according to times. The 1976 White Paper has a certain amount of statements concerning “trading nation.” It states that, in order to pursue the stable development of the Japanese economy and ensure the improvement of people’s lives, the stable development of trade is indispensable. It also states that Japan should respond to economic trends both at home and abroad in a dynamic manner... it is required to establish a more sophisticated relationship of international division of labor, and this is a path for Japan, a trading nation, to take.

The year 2011 turned to be a year of trade environment of difficulty that Japan has seldom experienced. However, despite such a circumstance, efforts are spreading to channel growth potential into Japan by disseminating the value unique to Japan to overseas through goods and services. It is hoped that this white paper will help deepen the understanding of today's significance of the “trading nation.”

